# TAX COURT CASE UPDATE

**Citation**:

*Aries Communications Inc. and Subsidiaries v. Commissioner*, T.C. Memo 2013-97, April 10, 2013.

**Overview**:

The Tax Court has determined how much of the amount paid by a corporation to its chief financial officer (CFO) and sole shareholder (including "catchup" payments for undercompensated prior years) was reasonable compensation deductible by the corporation under Code Section 162.

**The Facts**:

For compensation paid by an employer to be deductible under Code Section 162, the amount must be reasonable, and the payment must be purely for services rendered. What is reasonable depends on the facts and circumstances of each case.

The Ninth Circuit Court of Appeals (to which an appeal of this case would lie) uses five factors to determine the reasonableness of compensation, with no single factor being determinative: (1) the employee's role in the company; (2) comparison with other companies; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) internal consistency in compensation (*Elliotts, Inc*., (CA 9 1983) 52 AFTR 2d 83-5976). The Ninth Circuit also considers an additional factor-whether an independent investor would be willing to compensate the employee as he was so compensated (the "independent investor" test). Compensation for prior years' services ("catchup payments") can be deductible in the current year as long as the employee was actually undercompensated in prior years and the current payments are intended as compensation for past services

N. Arthur Astor was president, CFO, and sole shareholder of Aries Communications Inc. (“Aries”) from its incorporation in 1983. Mr. Astor acted as general manager of each of Aries' radio stations. He was a "hands-on" manager who was actively involved in many aspects of Aries' day-to-day operations. His duties included: (1) oversight of Aries' other management personnel; (2) planning and overseeing the execution of programming; (3) negotiating and communicating with Aries' lenders; (4) participating in sales meetings; and (5) communicating with outside advisers (such as lawyers and accountants).

Aries had two subsidiaries, Orange Broadcasting Corp. (“Orange”) and North County Broadcasting Corp. (“North County”). In May 2003, Orange sold its FCC license for 94.3 FM for $35 million. In April 2004, North County sold certain assets of 92.1 FM, including FCC licenses, equipment, engineering data, and selected contracts, for $18 million. Mr. Astor was personally involved in both sales and instrumental in the significant increase in the sales price from the initial offering of $18 million to $35 million for 94.3 FM, and from $12 million to $18 million for

92.1 FM. Mr. Astor also guaranteed $20 million in loans from Goldman Sachs Credit Partners L.P. to Orange.

Aries had gross receipts of over $4.5 million before it sold off these major assets. However, it lost money each year from 1999 to 2002. Immediately after the two years of the major asset sales, it began losing money again.

On its return for the tax year ending Aug. 31, 2004, Aries claimed a deduction for $6,896,974 of compensation paid to Mr. Astor. On audit, the IRS disallowed $6,086,752 of this amount, determining a deficiency of $2,676,002.

## Discussion:

The Court reviewed six factors for determining reasonableness and found them either favoring the reasonableness of the compensation, not favorable or neutral.

Employee's role. Both Aries' and the IRS's experts agreed that Mr. Astor was Aries' most important employee. He facilitated the sale of Aries' assets for prices far exceeding the buyers' original offers. Further, Mr. Astor also facilitated the Goldman Sachs debt by way of his personal guarantee (favorable factor).

Comparison with other companies. Mr. Astor had significant involvement in his executive capacity, acquiring, managing, and selling the investments. He was responsible for increasing the sales price from $12 million to $18 million (or by 50 percent). Even given his dual status as shareholder and chief executive officer, his efforts as an employee were still entitled to reasonable compensation for services rendered. The Tax Court, using its best judgment, found that Mr. Astor's appropriate bonus would be one-third of the increase in the sale price (i.e., $2 million) (not a favorable factor).

Company's character and condition. Aries was a large, asset-laden, complex business with a negative net income and a bleak financial picture despite the successful asset sale during the year at issue. The facts suggested the possibility that Aries was thinly capitalized (not a favorable factor).

Potential conflicts of interest. An independent investor would have desired the highest prices for the assets and rewarded Mr. Astor for his shrewd negotiations to that end. However, as Aries' owner, he also had a significant interest in getting the highest price for the assets and then receiving the reward as salary deductible by Aries instead of as a nondeductible dividend. In addition, Mr. Astor was well compensated ($2,074,983) for his work in investing in and maintaining Aries' major assets in the year immediately before the year at issue (when the first major asset sale took place) (not a favorable factor).

Internal consistency. Mr. Astor's compensation was not awarded under a structured, formal, consistently applied program. Accordingly, it was suspect. However, Mr. Astor's compensation included amounts for prior years of hard work for which he was undercompensated (neutral factor).

Independent investor standard. Aries had a net income of $4,025,956, after taxes and the compensation packages were paid in the year at issue, and retained earnings of $12,725,862. The company had enough retained earnings to almost satisfy an investor even at 20 percent compounded annually after Mr. Astor's compensation was paid in 2004 (favorable factor).

## Conclusion:

The Tax Court, after reviewing all of the factors, held that Mr. Astor's compensation was not reasonable, and that Aries could not deduct the entire amount of the claimed compensation expense. However, the Court found that $2,660,899 – Mr. Astor's fixed salary of $199,274 plus $461,625 of underpayments for the four years reviewed by the Court, plus the $2 million bonus - was deductible as reasonable compensation.